

**SUMMARY ANALYSIS OF AMENDED BILL**

Author: Migden Analyst: Gail Hall Bill Number: SB 105  
 Related Bills: See Prior Analysis Telephone: 845-6111 Amended Date: June 20, 2007  
 Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Registered Domestic Partnerships/Tax Treatment Same As Married Couple Except Where Treatment Would Result In Specified Treatment Under Federal Law

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED

☒ March 19, 2007, STILL APPLIES.

☒ OTHER – See comments below.

**SUMMARY**

This bill would clarify and resolve issues relating to the new California Registered Domestic Partner (RDP) personal income tax filing requirement.

**SUMMARY OF AMENDMENTS**

The June 20, 2007, amendments made the following changes:

- Added exceptions to the general rule that an RDP and former RDP shall be treated as the spouse of a taxpayer for California purposes in matters related to federally-qualified deferred compensation plans and tax-favored accounts.
- Revised the definition of "adjusted gross income" (AGI) for limitation purposes for RDPs and former RDPs.
- Added a provision specifying that no penalty would be imposed for any underpayment of tax resulting from the provisions added by this bill or SB 1827 (Migden, Stats. 2006, Ch. 802) for taxable year 2007.

Board Position:

\_\_\_\_\_ S      \_\_\_\_\_ NA      \_\_\_\_\_ NP  
 \_\_\_\_\_ SA      \_\_\_\_\_ O      \_\_\_\_\_ NAR  
 \_\_\_\_\_ N      \_\_\_\_\_ OUA      ☒ PENDING

Legislative Director

Date

Brian Putler

7/20/07

As a result of the amendments, the "SUMMARY," "FEDERAL/STATE LAW," "THIS BILL," and "ECONOMIC IMPACT" discussions in the department's analysis of the bill as amended March 19, 2007, have been revised. The remainder of that analysis still applies, except that an additional implementation consideration and technical consideration are provided.

## **POSITION**

Pending.

## **ANALYSIS**

### **FEDERAL/STATE LAW**

The following supplements the FEDERAL/STATE LAW discussion in the department's analysis of the bill as amended March 19, 2007.

#### Federally-Qualified Deferred Compensation Plans (ERISA)

Current federal law allows an employer that participates in a federally-qualified deferred compensation plan to deduct contributions paid to the qualified plan on behalf of employees even though these contributions are not currently taxable to the employees. These provisions are also applicable for California purposes. The federal tax rules parallel provisions of the Employee Retirement Income Security Act (ERISA), which affirmatively preempts state law.

Current federal law known as the "Defense of Marriage Act" prohibits RDPs from being treated as spouses. Consequently, RDPs are treated as single individuals for federal purposes instead of spouses that are married or members of the same family. However, RDPs are required to be treated as spouses under current state law. An administrator of a federally qualified deferred compensation plan covered by ERISA would be prevented from treating an RDP as a spouse because ERISA preempts state law. The California Constitution<sup>1</sup> provides that the department has no power to refuse to enforce any California statute that is preempted by federal law. If California law required federally qualified plans to treat RDPs as spouses, the plan could not be qualified for federal and state purposes.

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<sup>1</sup> Article 3, Section 3.5.

### Tax-Favored Accounts

Current federal law has established several tax-favored special purpose accounts that include Archer Medical Savings Accounts (MSAs), Individual Retirement Accounts (IRAs), education savings accounts (529 accounts), and Coverdell education savings accounts. These tax-favored accounts allow taxpayers to get special tax treatment for amounts accumulated to pay for particular expenses. Contributions to some accounts are deductible and tax on income earned on amounts in these accounts may be deferred or avoided. In some cases, eligibility is limited to certain taxpayers and may depend on the circumstances of a spouse or provide special rules for married individuals. In general, current state law conforms to the federal treatment for these tax-favored accounts.

Current state law treats RDPs as spouses; however, current federal law treats RDPs as single taxpayers. An RDP who is an eligible account owner for state tax purposes may not be eligible as an account owner for federal purposes. For example, the transfer of a tax-favored account from one RDP to another RDP incident to dissolution of a domestic partnership would continue to be treated as a tax-favored account under current state law but would no longer be treated as a tax-favored account under current federal law, creating a California-only tax favored account.

### Federal AGI

Federal AGI is defined under current federal law for personal income taxpayers as gross income from all sources not specifically excluded, minus certain "above the line"<sup>2</sup> deductions such as moving expenses, alimony paid, and IRA deductions. Federal AGI is used as a basis for various calculations, including determining the limitation on certain itemized deductions such as medical expenses and miscellaneous deductions. Current state law requires that, for limitation purposes, taxpayers use the AGI as reflected on their federal return. In addition, many California personal income tax returns start its calculation at the amount of AGI reported on the federal tax return.

Last year, California law was amended<sup>3</sup> to require RDPs to file their California income tax returns using the same rules applicable to married individuals. Effective January 1, 2007, RDPs are required to file personal income tax returns as either: (1) married filing joint or (2) married filing separate. Because RDPs are not allowed to file a joint federal return, this law also provided a rule for calculating joint federal AGI. The rule provides that RDPs shall combine the amounts reflected as AGI on the federal income tax return of each RDP to determine their joint federal AGI.

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<sup>2</sup> Tax deductions, other than the standard deduction or itemized deductions that are subtracted from income to calculate AGI.

<sup>3</sup> SB 1827 (Migden, Stats. 2006, Ch. 802).

### Underpayment Penalty

Under current state and federal laws, taxpayers generally are subject to a penalty for any underpayment of estimated tax. The penalty is an amount equal to the underpayment rate<sup>4</sup> multiplied by the amount of the underpayment. State and federal laws have historically allowed exceptions to the estimated tax underpayment penalty when the underpayment resulted from a specified legislative change.

### THIS BILL

This bill would clarify that an RDP or former RDP be treated as a spouse or former spouse, respectively, for personal income tax and corporation tax purposes. In addition, this bill would provide the following exceptions to RDPs being treated as spouses for California purposes:

1. Where treatment would result in the classification of a business entity for California purposes differently than for federal purposes. For example, this exception would avoid an S corporation meeting the 100 shareholder requirement for state purposes and not for federal purposes because there were two RDP shareholders that for federal purposes put the total amount to 101 shareholders, disqualifying the S corporation status under federal law.
2. Where treatment would result in the disqualification of a federally qualified deferred compensation plan under the rules established by the Internal Revenue Code (IRC).
3. Where treatment would result in the creation of a California only tax-favored account that would not be qualified for federal income tax purposes. A "tax favored account" means an individual account, plan, or arrangement that is exempt from tax under federal law and includes an Archer MSA, IRA, qualified tuition program, and a Coverdell education savings account.

This bill would revise current law's rule with respect to how RDPs calculate their joint federal AGI. The new rule would calculate joint federal AGI as the amount that would have been computed on a federal tax return if the RDPs would have been allowed to file a joint or separate federal tax return and used the same filing status on the federal return that was used on the California tax return.

This bill would prohibit RDPs from being assessed an underpayment of estimated tax penalty for the 2007 taxable year to the extent the underpayment was created by the provisions of this bill and/or the new California tax filing requirement for RDPs (SB 1827).

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<sup>4</sup> The underpayment rate is the sum of the Federal short-term rate, as determined by the Secretary, and three percentage points.

## **IMPLEMENTATION CONSIDERATION**

It is unclear whether legal unions between two individuals formed in other states that have a filing requirement in California and are substantially equivalent to a California registered domestic partner relationship would be required to use the filing status in California of married filing joint or married filing separate.

## **TECHNICAL CONSIDERATION**

This bill and AB 1561 (Calderon, 2007/2008) would both amend Revenue and Taxation Code section 17024.5; therefore, to ensure that the changes made to this section by these two bills would both become effective if both bills are chaptered, double-jointing language is provided in the attached amendments.

## **ECONOMIC IMPACT**

### Revenue Estimate

The revenue impact for the provisions under SB 105 would be inconsequential.

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

#### Clarify RDPs Treated As Spouses

The provision that would treat RDPs as spouses or former spouses is declaratory of existing law and would have no impact on state income tax revenue.

#### Shareholders/S Corporations

The provision that would exclude RDPs from being treated as spouses for S corporation purposes would have no revenue impact. There could be circumstances under which a particular business entity classification type would be allowed under state law but not under federal law (e.g., an S-corporation that would exceed the limit on the number of owners if RDPs were counted separately, but not if they are counted jointly). The department is unaware of any specific entities that would be classified differently for state purposes because shareholders are RDPs. This estimate assumes that taxpayers generally follow federal law when choosing an entity type because federal law is more restrictive with respect to entity types. It is anticipated that businesses will not suffer adverse consequences from entity reclassifications under current state law.

### Federally-Qualified Deferred Compensation Plans and Tax-Favored Accounts

The provisions that would exclude RDPs from being treated as spouses for purposes of a federally qualified deferred compensation plan or a tax-favored account would have no revenue impact. Treatment of RDPs as spouses for California purposes could result in a plan being disqualified by the administrator for federal purposes or require an administrator to create a "California only" tax favored account. It is assumed that RDPs generally would follow federal requirements, therefore, no revenue impact for these provisions are anticipated.

### RDPs' Federal AGI

Under state current law, federal AGI for RDPs is calculated by summing the AGI reported on the federal tax return of each partner. Under this provision, the Federal AGI would be calculated as if the partners were married. Under limited circumstances, these two methods could result in a different calculation of AGI. Typically, this could happen with the capital loss limitation or when netting capital losses and capital gains. The calculation of AGI also has a ripple effect with respect to itemized deductions subject to an AGI threshold (e.g., medical expenses). Circumstances exist where some will have an advantage and some will have a disadvantage as a result of changing how AGI would be calculated. Although the revenue impact cannot be quantified, any net revenue effects are anticipated to be inconsequential.

### Penalty

There would be no revenue impact from this provision.

Under current law, RDPs are required to use the filing status married filing joint or married filing separate for the 2007 tax year. To date, no underpayment penalties have been assessed that are associated with this provision. Under this provision, potentially fewer penalties would be assessed than otherwise.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 105  
As Amended June 20, 2007

AMENDMENT 1

On page 9, after SEC. 2, insert:

"SEC. 2.5 Section 17024.5 of the Revenue and Taxation Code is amended to read:

17024.5. (a) (1) Unless otherwise specifically provided, the terms "Internal Revenue Code," "Internal Revenue Code of 1954," or "Internal Revenue Code of 1986," for purposes of this part, mean Title 26 of the United States Code, including all amendments thereto as enacted on the specified date for the applicable taxable year as follows:

Taxable Year	Specified Date of Internal Revenue Code Sections
(A) For taxable years beginning on or after January 1, 1983, and on or before December 31, 1983.....	January 15, 1983
(B) For taxable years beginning on or after January 1, 1984, and on or before December 31, 1984.....	January 1, 1984
(C) For taxable years beginning on or after January 1, 1985, and on or before December 31, 1985.....	January 1, 1985
(D) For taxable years beginning on or after January 1, 1986, and on or before December 31, 1986.....	January 1, 1986
(E) For taxable years beginning on or after January 1, 1987, and on or before December 31, 1988.....	January 1, 1987
(F) For taxable years beginning on or after January 1, 1989, and on or before December 31, 1989.....	January 1, 1989
(G) For taxable years beginning on or after January 1, 1990, and on or before December 31, 1990.....	January 1, 1990
(H) For taxable years beginning on or after January 1, 1991, and on or before December 31, 1991.....	January 1, 1991

(I) For taxable years beginning  
on or after January 1, 1992, and  
on or before December 31, 1992..... January 1, 1992

(J) For taxable years beginning  
on or after January 1, 1993, and  
on or before December 31, 1996..... January 1, 1993

(K) For taxable years beginning  
on or after January 1, 1997, and  
on or before December 31, 1997..... January 1, 1997

(L) For taxable years beginning  
on or after January 1, 1998, and  
on or before December 31, 2001..... January 1, 1998

(M) For taxable years beginning  
on or after January 1, 2002, and  
on or before December 31, 2004..... January 1, 2001

(N) For taxable years beginning  
on or after January 1, ~~2005~~ 2005, and  
on or before December 31, 2006..... January 1, 2005

(O) For taxable years beginning  
on or after January 1, 2007..... January 1, 2007

(2) (A) Unless otherwise specifically provided, for federal laws enacted on or after January 1, 1987, and on or before the specified date for the taxable year, uncodified provisions that relate to provisions of the Internal Revenue Code that are incorporated for purposes of this part shall be applicable to the same taxable years as the incorporated provisions.

(B) In the case where Section 901 of the Economic Growth and Tax Relief Act of 2001 (Public Law 107-16) applies to any provision of the Internal Revenue Code that is incorporated for purposes of this part, Section 901 of the Economic Growth and Tax Relief Act of 2001 shall apply for purposes of this part in the same manner and to the same taxable years as it applies for federal income tax purposes.

(3) Subtitle G (Tax Technical Corrections) and Part I of Subtitle H (Repeal of Expired or Obsolete Provisions) of the Revenue Reconciliation Act of 1990 (Public Law 101-508) modified numerous provisions of the Internal Revenue Code and provisions of prior federal acts, some of which are incorporated by reference into this part. Unless otherwise provided, the provisions described in the preceding sentence, to the extent that they modify provisions that are incorporated into this part, are declaratory of existing law and shall be applied in the same manner and for the same periods as specified in the Revenue Reconciliation Act of 1990.

(b) Unless otherwise specifically provided, when applying any provision of the Internal Revenue Code for purposes of this part, a reference to any of the following is not applicable for purposes of this part:

(1) Except as provided in Chapter 4.5 (commencing with Section 23800) of Part 11 of Division 2, an electing small business corporation, as defined in Section 1361(b) of the Internal Revenue Code.



(2) Domestic international sales corporations (DISC), as defined in Section 992(a) of the Internal Revenue Code.

(3) A personal holding company, as defined in Section 542 of the Internal Revenue Code.

(4) A foreign personal holding company, as defined in Section 552 of the Internal Revenue Code.

(5) A foreign investment company, as defined in Section 1246(b) of the Internal Revenue Code.

(6) A foreign trust, as defined in Section 679 of the Internal Revenue Code.

(7) Foreign income taxes and foreign income tax credits.

(8) Section 911 of the Internal Revenue Code, relating to United States citizens living abroad.

(9) A foreign corporation, except that Section 367 of the Internal Revenue Code shall be applicable.

(10) Federal tax credits and carryovers of federal tax credits.

(11) Nonresident aliens.

(12) Deduction for personal exemptions, as provided in Section 151 of the Internal Revenue Code.

(13) The tax on generation-skipping transfers imposed by Section 2601 of the Internal Revenue Code.

(14) The tax, relating to estates, imposed by Section 2001 or 2101 of the Internal Revenue Code.

(c) (1) The provisions contained in Sections 41 to 44, inclusive, and Section 172 of the Tax Reform Act of 1984 (Public Law 98-369), relating to treatment of debt instruments, is not applicable for taxable years beginning before January 1, 1987.

(2) The provisions contained in Public Law 99-121, relating to the treatment of debt instruments, is not applicable for taxable years beginning before January 1, 1987.

(3) For each taxable year beginning on or after January 1, 1987, the provisions referred to by paragraphs (1) and (2) shall be applicable for purposes of this part in the same manner and with respect to the same obligations as the federal provisions, except as otherwise provided in this part.

(d) When applying the Internal Revenue Code for purposes of this part, regulations promulgated in final form or issued as temporary regulations by "the secretary" shall be applicable as regulations under this part to the extent that they do not conflict with this part or with regulations issued by the Franchise Tax Board.

(e) Whenever this part allows a taxpayer to make an election, the following rules shall apply:

(1) A proper election filed with the Internal Revenue Service in accordance with the Internal Revenue Code or regulations issued by "the secretary" shall be deemed to be a proper election for purposes of this part, unless otherwise provided in this part or in regulations issued by the Franchise Tax Board.

(2) A copy of that election shall be furnished to the Franchise Tax Board upon request.

(3) (A) Except as provided in subparagraph (B), in

order to obtain treatment other than that elected for federal purposes, a separate election shall be filed at the time and in the manner required by the Franchise Tax Board.

(B) (i) If a taxpayer makes a proper election for federal income tax purposes prior to the time that taxpayer becomes subject to the tax imposed under this part or Part 11 (commencing with Section 23001), that taxpayer is deemed to have made the same election for purposes of the tax imposed by this part, Part 10.2 (commencing with Section 18401), and Part 11 (commencing with Section 23001), as applicable, and that taxpayer may not make a separate election for California tax purposes unless that separate election is expressly authorized by this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001), or by regulations issued by the Franchise Tax Board.

(ii) If a taxpayer has not made a proper election for federal income tax purposes prior to the time that taxpayer becomes subject to tax under this part or Part 11 (commencing with Section 23001), that taxpayer may not make a separate California election for purposes of this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001), unless that separate election is expressly authorized by this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001), or by regulations issued by the Franchise Tax Board.

(iii) This subparagraph applies only to the extent that the provisions of the Internal Revenue Code or the regulation issued by "the secretary" authorizing an election for federal income tax purposes apply for purposes of this part, Part 10.2 (commencing with Section 18401) or Part 11 (commencing with Section 23001).

(f) Whenever this part allows or requires a taxpayer to file an application or seek consent, the rules set forth in subdivision (e) shall be applicable with respect to that application or consent.

(g) When applying the Internal Revenue Code for purposes of determining the statute of limitations under this part, any reference to a period of three years shall be modified to read four years for purposes of this part.

(h) When applying, for purposes of this part, any section of the Internal Revenue Code or any applicable regulation thereunder, all of the following shall apply:

(1) References to "adjusted gross income" shall mean the amount computed in accordance with Section 17072, except as provided in paragraph (2).

(2) (A) Except as provided in subparagraph (B), references to "adjusted gross income" for purposes of computing limitations based upon adjusted gross income, shall mean the amount required to be shown as adjusted gross income on the federal tax return for the same taxable year.

(B) In the case of registered domestic partners ~~filing a joint return under Section 18521~~ and former registered domestic partners, adjusted gross income, for the purposes of computing limitations based upon adjusted gross income, shall mean the ~~total of the amount required to be shown~~

~~as adjusted gross income on the a federal tax return for the same taxable year of each registered domestic partner~~ computed as if the registered domestic partner or former registered domestic partner was treated as a spouse or former spouse, respectively, for federal income tax purposes, and used the same filing status that was used on the state tax return for the same taxable year.

(3) Any reference to "subtitle" or "chapter" shall mean this part.

(4) The provisions of Section 7806 of the Internal Revenue Code, relating to construction of title, shall apply.

(5) Any provision of the Internal Revenue Code that becomes operative on or after the specified date for that taxable year shall become operative on the same date for purposes of this part.

(6) Any provision of the Internal Revenue Code that becomes inoperative on or after the specified date for that taxable year shall become inoperative on the same date for purposes of this part.

(7) Due account shall be made for differences in federal and state terminology, effective dates, substitution of "Franchise Tax Board" for "secretary" when appropriate, and other obvious differences.

(8) Except as otherwise provided, any reference to Section 501 of the Internal Revenue Code shall be interpreted to also refer to Section 23701.

(i) Any reference to a specific provision of the Internal Revenue Code shall include modifications of that provision, if any, in this part."

#### AMENDMENT 2

On page 9, after "SEC. 3." insert:

"SEC. 4. Section 2.5 of this bill incorporates amendments to Section 17024.5 of the Revenue and Taxation Code proposed by this bill and AB 1561. It shall only become operative if (1) both bills are enacted and become effective on or before January 1, 2008, (2) each bill amends Section 17024.5 of the Revenue and Taxation Code, and (3) this bill is enacted after AB 1561, in which case Section 17024.5 of the Revenue and Taxation Code, as amended by AB 1561, shall remain operative only until the operative date of this bill, at which time Section 2.5 of this bill shall become operative, and Section 2 of this bill shall not become operative."

#### AMENDMENT 3

On page 9, line 29, strikeout "SEC. 4." and insert:

"SEC. 5."